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5 UNITED STATES DISTRICT COURT
6 EASTERN DISTRICT OF WASHINGTON
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8 CITY OF ROSEVILLE EMPLOYEES'
9 RETIREMENT SYSTEM, Individually
10 and on Behalf of All others Similarly
11 Situated,
12 Plaintiff,
13 v.
14 STERLING FINANCIAL
15 CORPORATION, HAROLD B. GILKEY,
16 and DANIEL G. BYRNE,
17 Defendant.
18

NO. 2:09-cv-00368-SAB

**ORDER GRANTING
DEFENDANTS' MOTION TO
DISMISS CONSOLIDATED
AMENDED COMPLAINT**

19 Before the Court is Defendants' Motion to Dismiss Consolidated Amended
20 Complaint for Violation of the Federal Securities Laws, ECF No. 113;
21 Defendants' Request for Judicial Notice and Notice of Incorporation, ECF No.
22 119; and Defendants' Supplemental Request for Judicial Notice and Notice of
23 Incorporation by Reference, ECF No. 126. A hearing on the motions was held on
24 August 13, 2014, in Spokane, Washington. Plaintiff was represented by
25 Christopher P. Seefer and Laura J. Black. Defendants were represented by Barry
26 M. Kaplan and Gregory L. Watts.

27 This is the second time around for the parties in arguing the Motion to
28 Dismiss and the first time for this Judge. Previously, Judge Shea entered an Order

**ORDER GRANTING DEFENDANTS' MOTION TO DISMISS
CONSOLIDATED AMENDED COMPLAINT ~ 1**

granting Defendants' Motion to Dismiss Consolidated Complaint, but permitting Plaintiff to file an Amended Complaint. Plaintiff did so, and Defendants now move for dismissal on the Amended Consolidated Complaint. In ruling on Defendants' Motion to Dismiss, the Court does not intend to revisit prior rulings made by Judge Shea. Accordingly, this Order will only address new claims and theories that were not presented in Plaintiff's Consolidated Complaint.¹

A. Legal Standard for Plaintiff's Claims

1. Section 10(b) Claim

Private federal securities fraud actions are based upon federal securities statutes and their implementing regulations. Section 10(b) of the Securities Exchange Act of 1934 forbids (1) the "use or employ[ment] . . . of any . . . deceptive device," (2) "in connection with the purchase or sale of any security," and (3) "in contravention of" Securities and Exchange Commission "rules and regulations." 15 U.S.C. § 78j(b). Pursuant to this section, the SEC promulgated Rule 10b-5, which makes it unlawful:

(1) to employ any device, scheme, or artifice to defraud;

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the

¹ The Court adopts Judge Shea's reasoning in granting, in part, and denying, in part Defendants' Requests for Judicial Notice and Notice of Incorporation by Reference. *See* ECF No. 96, at 17-21. Similar to Judge Shea, in resolving Defendants' Motion, the Court finds it unnecessary to consider the truthfulness of the judicially noticeable documents Defendants have submitted. Rather, to the extent the documents contain out-of-court representations, the Court takes judicial notice of the fact that the representations were made, but does not take judicial notice of the truthfulness of the representation. *See Lee v. City of Los Angeles*, 250 F.3d 668, 690 (9th Cir. 2001).

1 light of the circumstances under which they were made, not
2 misleading, or

3 (3) to engage in any act, practice, or course of business which
4 operates or would operate as a fraud or deceit upon any person, in
5 connection with the purchase or sale of any security.

6 17 C.F.R. § 240.10b-5 (2004).

7 Taken together, courts have generally recognized that in order to adequately
8 plead a private securities fraud action, the plaintiff must allege: (1) material
9 misrepresentation or omission by the defendant; (2) scienter; (3) a connection
10 between the misrepresentation or omission and the purchase or sale of a security;
11 (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6)
12 loss causation. *Police Retirement System of St. Louis v. Intuitive Surgical Inc.*, __
13 F.3d __, 2014 WL 3451566 (July 16, 2014) (citing *Halliburton Co. v. Erica P.*
14 *John Fund, Inc.*, __ U.S. __, 134 S.Ct. 2398 (2014)).

15 **2. Section 20(a) Claim**

16 In order to prove a prima facie case under Section 20(a) of the Securities
17 Exchange Act of 1934, a plaintiff must prove: (1) a primary violation of federal
18 securities law; and (2) that the defendant exercised actual power or control over
19 the primary violator. *No. 84 Employer-Teamster Joint Council Pension Trust Fund*
20 *v. Am. West. Holding Corp.*, 320 F.3d 920, 945 (9th Cir. 2003).

21 Section 20(a) claims may be dismissed summarily if a plaintiff fails to
22 adequately plead a primary violation of section 10(b). *Zucco Partners, LLC v.*
23 *Digimarc Corp.*, 552 F.3d 981, 990 (9th Cir. 2009).

24 **B. Pleading Standards**

25 The Ninth Circuit has cautioned that plaintiffs in private securities fraud
26 class actions face “formidable pleading requirements to properly state a claim and
27 avoid dismissal under Fed. R. Civ. P. 12(b)(6).” *Metzler, Inc. GMBH v. Corinthian*
28 *Colls., Inc.*, 540 F.3d 1049, 1055 (9th Cir. 2008).

1 **1. Fed. R. Civ. P. 12(b)(6)**

2 Rule 12(b)(6) of the Federal Rules of Civil Procedure permits a defendant to
 3 seek dismissal of a complaint that “fail[s] to state a claim upon which relief can be
 4 granted.” Fed. R. Civ. P. 12(b)(6). The Court should not dismiss the complaint if
 5 the plaintiff has stated “enough facts to state a claim to relief that is plausible on
 6 its face.” *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007). A claim has facial
 7 plausibility when the plaintiff pleads factual content that allows the court to draw
 8 reasonable inferences that the defendant is liable for the misconduct alleged.
 9 *Ashcroft v. Iqbal*, 556 U.S. 662, 678-79 (2009). The Court accepts all factual
 10 allegations in the complaint as true and construes them in the light most favorable
 11 to the nonmoving party, except the Court is not required to accept legal
 12 conclusions cast in the form of factual allegations if those conclusions cannot be
 13 reasonably drawn from the facts alleged. *Id.*

14 The court must consider the complaint in its entirety, as well as other
 15 sources courts ordinarily examine when ruling on a 12(b)(6) motion to dismiss, *i.e.*
 16 documents incorporated into the complaint by reference, and matters of which a
 17 court may take judicial notice. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551
 18 U.S. 308, 322 (2007).

19 **2. Fed. R. Civ. P. 9(b) and the Private Securities Litigation Reform**
 20 **Act (“PSLRA”) Pleading Requirements**

21 Federal R. Civ. P 9(b) and the Private Securities Litigation Reform Act
 22 (PSLRA) set forth additional pleading requirements. *Reese v. Malone*, 747 F.3d
 23 557, 568 (9th Cir. 2014). Under Rule 9(b), claims alleging fraud are subject to a
 24 heightened pleading requirement, which requires that a party “state with
 25 particularity the circumstances constituting fraud or mistake.” Fed. R. Civ. P. 9.
 26 Additionally, the PSLRA requires that the complaint plead with particularity both
 27 falsity and scienter. 15 U.S.C. § 78u-4(b)(1),(2).

28 **a. Pleading Requirements for Falsity and Materiality**

1 Under Rule 10b-5, the complaint must allege “falsity” by specifying each
2 allegedly misleading statement, why the statement was misleading, and if an
3 allegation is made on information and belief, all facts supporting that belief with
4 particularity. 18 U.S.C. § 78u-4(b)(1); *Reese*, 747 F.3d at 568. To meet the
5 materiality requirement of Rule 10b-5, the complaint must allege facts sufficient to
6 support the inference that there is “substantial likelihood that the disclosure of the
7 omitted fact would have been viewed by the reasonable investor as having
8 significantly altered the total mix of information made available.” *Police*
9 *Retirement Syst.*, 2014 WL 3451566 *4.

10 **b. Pleading Requirements for Scienter**

11 Scienter is defined as “a mental state embracing intent to deceive,
12 manipulate, or defraud.” *Reese*, 747 F.3d at 568. To adequately plead scienter, the
13 complaint must “state with particularity facts giving rise to a strong inference that
14 the defendant acted with the required state of mind.” 15 U.S.C. § 78u-4(b)(2)(A);
15 *Reese*, 747 F.3d at 568. The inference must be that “the defendant made false or
16 misleading statements either intentionally or with deliberate recklessness.” *Id.*
17 569. “Deliberate recklessness means that the reckless conduct ‘reflects some
18 degree of intentional or conscious misconduct.’” *Id.* Thus, mere recklessness or a
19 motive to commit fraud and opportunity to do so is not sufficient to establish a
20 strong inference of deliberate recklessness. *Id.* To meet the requirements of the
21 PSLRA, the plaintiff must plead “a highly unreasonable omission, involving not
22 merely simple, or even inexcusable negligence, but an extreme departure from the
23 standards of ordinary care, and which presents a danger of misleading buyers or
24 sellers that is either known to the defendant or is so obvious that the actor must
25 have been aware of it.” *Zucco Partners, LLC*, 552 F.3d at 991.

26 A “strong inference” of scienter exists if, when the allegations are accepted
27 as true, “a reasonable person would deem the inference of scienter cogent and at
28 least as compelling as any opposing inference one could draw from the facts

1 alleged.” *Tellabs, Inc.*, 551 U.S. at 324. It must be more than merely plausible or
2 reasonable. *Reese*, 747 F.3d at 569.

3 Ultimately, the Court must ask: “When the allegations are accepted as true
4 and taken collectively, would a reasonable person deem the inference of scienter at
5 least as strong as any opposing inference?” *Tellabs, Inc.*, 551 U.S. at 323. In doing
6 so, “the court must consider *all* reasonable inferences to be drawn from the
7 allegations, including inferences unfavorable to the plaintiffs.” *Metzler*, 540 F.3d
8 at 1061 (emphasis in original). Recently, the Ninth Circuit instructed that courts
9 should conduct a holistic review of the allegations to determine whether they
10 combine to create a strong inference of intentional or deliberate recklessness,
11 while also keeping in mind the individual allegations and the inferences drawn
12 from them. *In re VeriFone Holdings, Inc. Sec. Litig.*, 704 F.3d 694, 703 (9th Cir.
13 2012). Stated another way, courts are to examine individual allegations in order to
14 benchmark whether they are actionable, but also consider the allegations
15 collectively to examine the complaint as a whole. *Police Retirement System*, 2014
16 WL 3451566 at *4.

17 **C. Plaintiff’s Consolidated Amended Complaint**

18 Plaintiff is bringing a putative class-action lawsuit, alleging securities fraud
19 on behalf of all persons who purchased or otherwise acquired publically-traded
20 securities of Sterling Financial Corporation between July 23, 2008, and October
21 15, 2009 (the “Class Period”). Plaintiff is suing Sterling Financial Corporation and
22 its top officers for violations of the Securities Exchange Act of 1934 and the U.S.
23 Securities and Exchange Commission Rule 10b-5.

24 Defendant Sterling Financial Corporation is a bank holding company
25 operating through its two main banking subsidiaries—Sterling Savings Bank and
26 Golf Savings Bank. During the Class Period, Sterling Savings Bank was the
27 largest commercial bank headquartered in Washington with over \$12 billion of
28 assets and one of the largest regional community banks in the western United

1 States.

2 Defendant Harold Gilkey co-founded Sterling and was, at all relevant times,
3 President, CEO, Principal Executive Officer, Chairman of the Board at Sterling,
4 and a director of Sterling Savings Bank. He was also Chairman of the Board and
5 CEO of Golf Savings Bank, and director of Intervest-Mortgage Investment
6 Company, a wholly owned subsidiary of Sterling Savings Bank.

7 Defendant Daniel Byrne joined Sterling in 1983. At all relevant times, he
8 was Sterling's CFO, Executive Vice President of Finance, and Assistant Secretary.
9 He was also Assistant Secretary of Sterling Savings Bank and Golf Savings Bank
10 during the relevant time period. Mr. Byrne is a Certified Public Accountant.

11 According to Plaintiff, Gilkey and Byrne possessed the power and authority
12 to control the contents of Sterling's communications to the market, including
13 quarterly and yearly SEC filings, press releases, conference call statements and
14 presentations to securities analysts, portfolio managers, and institutional investors.
15 They were provided with copies of the Company's reports, press releases and
16 communications alleged to have been misleading prior to their issuance and had
17 the power, control, means, ability and opportunity to prevent their issuance or
18 cause them to be not misleading.

19 On December 13, 2006, federal banking agencies issued the Interagency
20 Policy Statement on the Allowance for Loan and Lease Losses (ALLL). This
21 statement revised the 1993 policy statement on the ALLL to ensure consistency
22 with Generally Accepted Accounting Principles (GAAP). Plaintiff alleges that
23 Defendants failed to follow this statement, and as a result, overstated its earnings
24 and capital during the Class Period.

25 Between 2007 and 2009, the levels of adversely classified and
26 nonperforming construction loans held by Sterling Financial Corporation
27 increased as the residential real estate market was in the midst of an unprecedented
28 and rapid decline. During the Class Period, Sterling Financial Corporation filed

1 ten quarterly (10-Q) reports with the SEC and also issued press releases that
2 summarized the reports. Notably, during this time, the allowance for credit losses
3 increased from \$168.7 million in 2Q08 to \$355.4 million in 4Q09.² Non-
4 performing assets increased from \$303.4 million in 2Q08 to \$987.4 million in
5 4Q09. Non-performing construction loans increased from \$240.9 million in 2Q08
6 to \$682.7 million in 4Q09.

7 In October, 2008, the Federal Deposit Insurance Corporation (FDIC) and
8 the Washington Department of Financial Institution (WDFI) conducted a joint
9 safety and soundness exam. According to Plaintiff, during this exam, it was
10 determined that Sterling was improperly including “potential” cash flows from
11 loan guarantors when determining the level of loan losses on collateral-dependent
12 loans. A Report of Examination detailing the findings was mailed to the Sterling
13 Financial Corporation Board on January 28, 2009. Following the completion of
14 the joint field visit in June, 2009, the FDIC and WDFI prepared a Notice of
15 Charges, and issued a joint Report of Visitation.

16 On October 12, 2009, the Sterling Financial Corporation Board fired Gilkey
17 and Heidi Stanley, the CEO of Sterling Savings Bank. According to Plaintiff, they
18 were fired because they had concealed from the Board the numerous unsafe and
19 unsound practices discovered by the regulators. On October 15, 2009, Sterling
20 Financial Corporation consented to the issuance of a Cease & Desist Order, which
21 required the bank to cease and desist from engaging in unsafe and unsound
22 banking practices discovered by the FDIC and WDIC. The Cease & Desist Order
23 required Sterling Financial Corporation to implement numerous corrective actions,
24

25 ² The Court adopts the parties’ methodology for referring to fiscal quarters and
26 years. Thus, fiscal quarters are identified as xQyy, with “x” being the quarter and
27 “yy” being the last two digits of the year. For example, 2Q08 represents the second
28 quarter of 2008 and 4Q09 represents the fourth quarter for 2009.

1 including:

- 2 • retain management capable of restoring all aspects of the bank to a
- 3 safe and sound condition
- 4 • assure effective oversight by the Board of Directors
- 5 • increase capital
- 6 • cease paying dividends
- 7 • review and revise ALLL and ALLL policy
- 8 • plan to reduce nonperforming assets (NFA)
- 9 • adopt and implement policy prohibiting loans to problem borrowers
- 10 • develop and adopt a plan to reduce commercial real estate loans
- 11 • develop a strategic plan to improve profitability and risk.³

12 Press releases issued by Sterling Financial Corporation immediately prior to
 13 and during the Class Period included the following statements attributed to
 14 Gilkey:

15 **July 22, 2008**

16 Early in this credit cycle, we implemented stringent measures
 17 to address softening credit quality. During the last three quarters, our
 18 credit team has generally identified, quantified and isolated the
 19 distressed assets, which primarily reside in our residential
 20 construction portfolio. Our credit department has also intensified its
 21 efforts toward credit resolution and we expect that it will take several
 22 quarters to resolve the issues related to non-performing assets. We are
 23 encouraged by the results we are seeing. We, however, remain
 24 cautious as parts of the Pacific Northwest continue to see pockets of
 credit deterioration.

25 ³On September 27, 2010, the FDIC and the WDFI terminated the Cease and Desist
 26 Order after Sterling Financial Corporation improved regulator relations, raised
 27 additional capital, enhanced governance, transformed the bank's culture and
 28 operations, and complied with the requirements of the Cease and Desist Order.

October 21, 2008

Sterling's results reflect some dislocations in the Pacific Northwest economy caused by a variety of factors, including global disruptions to the financial system and the Boeing union strike. These events created a slowdown in the sale of residential product and thereby affected our borrowers and elevated our credit costs. The Pacific Northwest is insulated, but not isolated, from the broader economy. Still, the Pacific Northwest remains relatively strong. Operationally, Sterling's execution was solid. We slightly reduced the size of our balance sheet while shifting our mix of assets away from residential construction. We grew our deposits. We controlled operating costs. Our liquidity and capital positions remained strong. Our credit administration team proactively managed loan portfolio risk. In sum, we are managing through a difficult credit cycle while maintaining a safe, sound and secure banking practice.

January 27, 2009

During the fourth quarter of 2008, we witnessed acceleration in the slowdown of the economy, which caused higher levels of credit stress among our borrowers and an elevation in the level of both our non-performing and classified assets. We, therefore, modified our approach in determining the fair market value of loans identified as impaired. The weakening economy, the increased charge-offs and declines in real estate appraisal values led to the higher level of credit provisioning in the quarter.

Additionally, the January 27, 2009 Press release included the following language:

Sterling has been proactively addressing credit quality issues within its construction portfolios. During the fourth quarter of 2007, Sterling made a strategic decision to reduce its level of residential construction commitments. During the first quarter of 2008, Sterling activated a Residential Construction Special Project Team to identify, manage and resolve credit quality issues. During the third quarter of 2008, Sterling separated its credit administration team into two dedicated teams: one to fix, repair and manage construction assets; and, the other to focus on generating strategic business and consumer assets. "Throughout the year, Sterling's bankers have been working in partnership with our borrowers to help avoid credit defaults and protect the bank from losses. Because of our efforts at early

1 intervention and remediation, we believe our level of classified assets
2 continues to be manageable and will eventually lead to beneficial
3 resolutions,” stated Mr. Gilkey.

4 Sterling modified its methodology in determining the fair value of
5 loans being tested for impairment during the quarter. The fair value is
6 now determined excluding the potential cash flows from certain
7 guarantors. To the extent that these guarantors are able to provide a
8 viable source of repayment, a recovery would be recorded upon
9 receipt.

10 In addition to the higher provisions during the quarter, in many cases,
11 Sterling re-assessed the accounting for real estate loans treated as
12 collateral dependent. As a result, Sterling now considers any
13 impairment on a collateral-dependent loan to be a confirmed loss and
14 charges off the impairment amount when the impairment is identified,
15 rather than establishing a specific allowance on impaired collateral-
16 dependent loans that would have been charged off when foreclosure
17 was probable. As a result of this change, the allowance for specific
18 impairment was reduced by approximately \$163.9 million and is not
19 reflected as part of net charge-offs.

20 **July 23, 2009**

21 . . . “Throughout this credit cycle, Sterling has acted proactively to
22 maintain health capital ratios and a strong liquidity position. Our
23 commitment is to continue maintaining a safe, sound and secure
24 banking practice for the benefit of customers, shareholders and
25 employees, said Mr. Gilkey.

26 Plaintiff obtained pleadings and internal company documents filed by
27 Sterling in borrower bankruptcy proceedings and in numerous lawsuits Sterling
28 filed against delinquent borrowers. According to Plaintiff, these documents
establish that Sterling was underreporting the level of nonperforming construction
loans and losses in 2Q08 and 3Q08, and that Sterling made loans to borrowers
when they had defaulted on other loans.

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1 During the Class Period, the price of Defendants' stock fell 80% from the
2 start of the period to the end of the period, and fell 92% from the highest price
3 during the class period.

4 Although Plaintiff's Amended Consolidated Complaint is 133 pages,
5 Plaintiff's claims can be consolidated into two theories:

6 (1) Defendants made materially false and misleading representations when
7 they assured investors that Sterling was maintaining safe, sound and secure
8 banking practices because the evidence demonstrates that it was not doing that;
9 and

10 (2) Defendants made materially false and misleading representations that
11 they were accurately reporting its financial results because the evidence
12 demonstrates that Sterling was not properly classifying assets (identifying them as
13 problem loans), not recording adequate loan loss provisions and charge-offs, and
14 not maintaining an adequate ALLL (Allowance for Loan and Lease Losses). ECF
15 No. 103.

16 The CAC identifies those actions by Defendants that Plaintiff characterizes
17 as "unsafe and unsound" banking practices.⁴ Plaintiff's theory is that if Defendants
18

19 ⁴The CAC identified the following unsafe and unsound practices: (1) including
20 "potential" cash flows from loan guarantors when determining the level of loan
21 losses on collateral-dependent loans; (2) giving unsecured loans to construction
22 loan borrowers so they could make payments on the construction loans; (3)
23 making loans to borrowers when they had defaulted on other loans; (4) failing to
24 maintain an adequate ALLL; and (5) failing to obtain updated appraisals or
25 valuations. It also alleges Defendants falsely represented that Sterling had
26 implemented stringent measures, *i.e.* had identified problem assets in the
27 construction loan portfolio; made false and misleading statements about the
28 reasons for the unexpected loan loss and goodwill impairment charge; falsely

1 promised Sterling was engaging in safe, sound, and secure banking practices and it
2 was not, then Defendants made material misrepresentations to its investors.

3 **D. Analysis**

4 Securities regulation serves many useful purposes, including: (1) to insure
5 the maintenance of fair and honest markets, 15 U.S.C. § 78b; *Basic Inc. v.*
6 *Levinson*, 485 U.S. 224, 230 (1988); (2) to provide investors with full disclosure
7 of material information concerning public offerings of securities in commerce,
8 *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976); (3) to protect investors
9 against fraud, *id.*; and (4) to promote ethical standards of honesty and fair dealing,
10 *id.* However, the Securities Act of 1932 does not serve to provide investors with
11 broad insurance against market losses. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336,
12 344 (2005); *see also Basic*, 485 U.S. at 353 (White, J.) (cautioning against
13 allowing a Rule 10b-5 action to be converted into a scheme of investor’s
14 insurance). That said, the Court is cognizant that it must balance the purposes of
15 the Securities Act against the purpose of the heightened pleading requirements as
16 set out in the Private Securities Litigation Reform Act, which is to protect
17 defendants from the cost of discovery and trial in unmeritorious cases. *See Tellabs,*
18 *Inc.*, 551 U.S. at 336 (J. Stevens, dissenting) (“The basic purpose of the
19 heightened pleading requirements in the context of securities fraud litigation is to
20 protect defendants from the costs of discovery and trial in unmeritorious cases.”).

21 Also, during the Class Period, the Court notes that the United States, and
22 indeed the world, was experiencing a global recession, rising unemployment,
23 widespread layoffs, bankruptcies, and foreclosures—all significant economic and
24 social circumstances that could contribute to lower stock prices. *See Dura*, 544
25 U.S. at 343 (“When the purchaser subsequently resells such shares, even at a lower
26

27 represented considerable slowdown in the growth rate of classified assets and
28 falsely represented that the level of classified assets had stabilized.

1 price, that lower price may reflect, not the earlier misrepresentations, but changed
2 economic circumstances, changed investor expectations, new industry-specific or
3 firm-specific facts, conditions, or other events, which taken separately or together
4 account for some or all of that lower price.”).

5 These considerations provide the lens through which the Court addresses
6 Defendants’ Motion to Dismiss.

7 **1. Scierter**

8 Plaintiff’s claims are based upon statements made by Defendants Gilkey and
9 Byrne and in the official filings signed by these individuals. They attempt to
10 satisfy the pleading requirement regarding corporate scierter with evidence Gilkey
11 and Byrne had the necessary mental state.

12 Here, Plaintiff has not met its burden of adequately pleading scierter.
13 Plaintiff faces a high hurdle in attempting to do so in this case in light of the fact
14 that Sterling’s independent auditors consistently provided unqualified opinions
15 regarding Sterling’s financial reports, and the FDIC never required it to restate any
16 of its financials, despite the issuance of the cease and desist order, and the FDIC’s
17 unilateral power to force companies to restate inaccurate financials. *See* 12 U.S.C.
18 § 1818(b); *see also Nolte v. Capital One Fin. Corp.*, 390 F.3d 311, 316 (4th Cir.
19 2004) (“Had Federal Regulators determined that Capital One’s past practices were
20 deficient, they could have applied corrective measures retroactively and forced the
21 company to restate its earnings to reflect retroactive adjustments.”)

22 Generally, allegations of scierter based on GAAP violations do not create
23 the requisite strong inference of scierter unless Plaintiff’s complaint alleges more.
24 *Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994). In the Ninth
25 Circuit, plaintiffs must plead particular facts showing that “the accounting
26 practices were so deficient that the audit amounted to no audit at all, or an
27 egregious refusal to see the obvious, or to investigate the doubtful, or that the
28 accounting judgments which were made were such that no reasonable accountant

1 would have made the same decisions if confronted with the same facts.” *DSAM*
2 *Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385, 390 (9th Cir. 2002)
3 (citation omitted). “[M]ere allegations that an accountant negligently failed to
4 closely review files or follow GAAP cannot raise a strong inference of scienter.”
5 *Id.*

6 Plaintiff primarily relies on the testimony of Confidential Witness 4 (CW4)
7 to support its allegations of scienter. A complaint relying upon statements from
8 confidential witnesses must pass two hurdles to satisfy the PSLRA pleading
9 requirements. *Zucco*, 552 F.3d at 995. First, the confidential witnesses must be
10 “described with sufficient particularity to establish their reliability and personal
11 knowledge. *Id.* Second, the statements themselves must be “indicative of scienter.”
12 *Id.*

13 CW4 was an executive at Sterling throughout the Class Period until he/she
14 left the company in 2010. CW4’s responsibilities included general financial
15 management, including financial reporting. The CAC attributes the following facts
16 to CW 4:

17 (a) During the 2008 and 2009 field visit, the FDIC determined the bank was
18 not properly classifying loans;

19 (b) During the 2008 examination, the FDIC discovered and directed the
20 bank to discontinue the unsafe and unsound practice of making unsecured loans to
21 construction loan borrowers that were used to make payments on their loans;

22 (c) During the 2008 examination, the regulators informed Sterling that
23 including potential cash flows from construction loan guarantors was contrary to
24 regulatory and accounting guidance;

25 (d) Gilkey insisted on setting the level of loan loss provisions in the 2008
26 budget to 40 million dollars;

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1 (e) CW4 heard from other bank personnel that the Board of Directors fired
2 Gilkey and Stanley because they were surprised by the Cease and Desist Order and
3 the findings of the regulators during the 2008 examination and 2009 field visit;

4 (f) Gilkey stated that the bank needed to hit certain numbers so it could
5 obtain capital through Troubled Asset Relief Program (“TARP”);

6 (g) Gilkey overruled other bank executives by continuing to originate
7 “higher risk construction loans in 2007,” which contributed to the increase in
8 classification and loan losses in 2008;

9 (h) Sterling made unsecured loans to Patrick McCourt, a real estate
10 developer;

11 (i) regulators downgraded many of the bank’s internal classifications; and

12 (j) Sterling approved loans that exceeded loan-to-value ratios.

13 CW4’s testimony does not meet the *Zucco* requirements because the
14 testimony fails to establish CW4’s personal knowledge and reliability, and also
15 fails to be indicative of scienter. CW4 does not claim to have communicated
16 directly with Gilkey or Byrne. Many of CW4’s allegations rely on multiple levels
17 of hearsay and speculation. He/she does not identify a single email, date, author,
18 recipient, or specific content of any communication. CW4 does not identify any
19 specific examples of downgrades or loans exceeding ratios. CW4 does not report
20 any statements made by the individual defendants that suggest that they knew
21 Sterling was not operating in a safe and sound manner, or that it was falsely
22 reporting its financials. At most, CW4’s testimony may indicate possible motive
23 and opportunity, but it does not rise to the level of demonstrating intent. *See*
24 *Reese*, 747 F.3d at 569 (“Facts showing mere recklessness or a motive to commit
25 fraud and opportunity to do so provide some reasonable inference of intent, but are
26 not independently sufficient.”). Without more, CW4’s testimony is not indicative
27 of scienter. It does not establish that Gilkey or Byrne made false or misleading
28 statements either knowingly, intentionally or with deliberate recklessness. CW4’s

1 testimony suggests that a healthy and robust internal debate took place at Sterling.
2 This is expected, particularly during a time of unprecedented economic
3 uncertainty.

4 The facts of the case actually negate any inference of scienter. It is
5 undisputed that Defendants Gilkey or Byrne did not trade a single share of stock to
6 capitalize on the alleged artificial inflation. Defendants held on to their stock at a
7 time when it is alleged they were fraudulently inflating the stock, and as a result,
8 they too experienced a significant loss in their stock value. Similarly, Defendants
9 Gilkey and Byrne received less in compensation during the Class Period than they
10 received before the Class Period. In fact, Gilkey declined a salary increase when it
11 was offered to him. Moreover, Plaintiff has not alleged or identified any
12 contemporaneous information or documents that conflicted with Defendants'
13 public representations.

14 The Court has reviewed Plaintiff's allegations holistically, and the
15 allegations do not create an inference of scienter that is nearly as compelling as the
16 far more likely alternative inference, namely that Defendants underestimated the
17 risk in their loan portfolios and failed to timely appreciate the near melt-down of
18 the construction, real estate, and financial markets. Plaintiff's allegations suggest
19 that Defendants may have exercised poor business judgment, but not that they
20 engaged in fraud. Plaintiff's allegations, reviewed collectively still do not evince
21 such fraudulent intent or deliberate recklessness as to make the inference of
22 scienter cogent.

23 **2. Misrepresentations of Operating in Safe and Sound Manner**

24 Plaintiff alleges Defendants falsely represented that Sterling was operating
25 in a safe and sound manner. Plaintiff contends that Defendants were doing the
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27
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1 opposite, namely operating in an unsafe and unsound manner.⁵

2 Statements of mere corporate puffery, “vague statements of optimism like
3 ‘good,’ ‘well-regarded,’ or other feel good monikers,” are not actionable because
4 “professional investors, and most amateur investors as well, know how to devalue
5 the optimism of corporate executives.” *In re Cutera Sec. Litig.*, 610 F.3d 1103,
6 1111 (9th Cir. 2010); *Glen Holly Ent., Inc. v. Tektronix, Inc.*, 352 F.3d 367, 379
7 (9th Cir. 2003) (finding no liability where the alleged misstatements “were
8 generalized, vague and unspecific assertions, constituting mere puffery upon
9 which a reasonable consumer could not rely.”). Statements that lack a standard
10 against which a reasonable investor could expect them to be pegged are puffery.
11 *See In re Wet Seal Inc. Sec. Litig.*, 518 F.Supp.2d 1148 (C.D. Calif. 2007).

12 Judge Shea found that the term “safe and sound” constitutes immaterial
13 corporate puffery, and was not an actionable term in a securities fraud claim.
14 Judge Shea also found that the statements in the Cease and Desist Order, *i.e.* that it
15 had reason to believe Sterling was operating in an unsafe and unsound manner, did
16 not provide support for Plaintiff’s claim. The Court adopts Judge Shea’s
17 reasoning.

18 In addition, the Court finds that the term, “safe and sound banking
19 practices” does not have a specific and formal regulatory and definitional
20

21 _____
22 ⁵In its CAC, Plaintiff identifies the following unsafe and unsound practices: (1)
23 improperly including “potential’ cash flows from loan guarantors when
24 determining the level of loan losses on collateral-dependent loans; (2) giving
25 unsecured loans to construction loan borrowers so they could make payments on
26 the construction loans; (3) making loans to borrowers when they had defaulted on
27 other loans; (4) failing to maintain an adequate ALLL; and (5) failing to obtain
28 updated appraisals or valuations.

1 meaning, notwithstanding the CAC's citation to various banking regulations, SEC
2 rules and regulations, and GAAP. Notably, the FDIC Manual states the following:

3 The concept of unsafe or unsound practices is one of general
4 application which touches upon the entire field of operations of a
5 banking institution. It would, therefore, be virtually impossible to
6 catalog with a single all-inclusive or rigid definition, the broad
7 spectrum of activities which are included by that term. Thus, an
8 activity not necessarily unsafe or unsound in every instance may be so
in a particular instance when considered in light of all relevant facts
pertaining to that situation.

9 ECF No. 116, Ex. 18 at 269.

10 Further, the Court finds that the term "safe and sound" is too general and
11 would not cause investors to rely upon it. If this generalized statement could
12 provide the basis for a securities fraud claim, the heightened requirements set out
13 in the PSLRA would be meaningless. Additionally, Defendants' use of the phrase
14 "safe and sound" practices was not unreasonable or reckless. Defendants' use of
15 the phrase was not an extreme departure from the standards of ordinary care and
16 did not present a danger of misleading buyers or sellers.

17 Moreover, Defendants' positive statements, such as "Sterling implemented
18 stringent measures to address softening credit quality;" "took a conservative
19 approach towards risk evaluation;" "accelerated loans going into nonperforming
20 status" whenever there were "indications of concern;" and Defendants' credit
21 administration team was proactively managing portfolio risk" are not more than
22 puffery that does not give rise to any securities fraud violations. *See ECA, Local*
23 *134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187,
24 205 (2nd Cir. 2009) (holding that the following statements were too general to
25 cause a reasonable investor to rely upon them: statements regarding "highly
26 disciplined risk management" and "standard-setting reputation for integrity."). The
27 Second Circuit noted that no investor would take such statements seriously in
28

1 assessing a potential investment because almost every investment bank made these
2 statements. *Id.* (“Finding the JPMC’s statements constitute a material
3 misrepresentation would bring within the sweep of federal securities laws many
4 routine representations made by investment institutions. We decline to broaden the
5 scope of securities laws in that manner.”). Similarly, Defendants’ statements that
6 its credit practices were stringent, conservative, and disciplined are generalizations
7 regarding its business practices, and thus, are not actionable.

8 Consequently, Plaintiff’s reliance on the terms “safe and sound” to anchor
9 its claim that Defendants made materially false and misleading representations
10 fails to meet the materiality requirements of the PSLRA.

11 **3. Misrepresentations about Sterling Financial Corporation’s** 12 **Financial Results**

13 Plaintiff asserts that, during the Class Period, Defendants falsely represented
14 that Sterling was accurately reporting its financial results. Plaintiff contends
15 Defendants failed to accurately classify assets, thereby underreporting the level of
16 nonperforming construction loans and loan losses.

17 A general allegation that the practices at issue resulted in a false report of
18 company earnings is not a sufficiently particular claim of misrepresentation. *In re*
19 *Daou Sys., Inc.*, 411 F.3d 1006, 1016 (9th Cir. 2005) (quoting *Greebel v. FTP*
20 *Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999)). “To properly state a claim for
21 account fraud, plaintiffs must plead facts sufficient to support a conclusion that
22 defendant prepared the fraudulent financial statements and the alleged financial
23 fraud was material.” *Id.* When pleading irregularities in revenue recognition, the
24 plaintiffs must plead (1) basic details as the approximate amount by which
25 revenues and earnings were overstated; (2) the products involved in the contingent
26 transaction; (3) the dates of any of the transactions; or (4) the identities of any of
27 the customers or company employees involved in the transactions. *Id.* Ultimately,
28 the Court must discern whether the alleged violations were minor or technical in

1 nature, or whether they constituted widespread and significant inflation of
2 revenue. *Id.* The plaintiff must show with particularity how the adjustments
3 affected the company's financial statements and whether they were material in
4 light of the company's overall financial position. *Id.*

5 Plaintiff has not met its burden to provide sufficient details of the alleged
6 fraudulent financial statements. Moreover, the failure of any agency to require
7 Sterling to restate its financials, the failure of the Cease and Desist Order to
8 specifically address any of the alleged accounting errors/misrepresentations, and
9 the fact that Plaintiff has not alleged that any external auditors counseled against
10 Sterling's accounting practices weigh against Plaintiff's allegations of accounting
11 fraud.

12 Plaintiff's calculations using missed payments to demonstrate the reported
13 amount of underperforming loans was understated does not take into account the
14 fact that the schedule of principal payments changes throughout the course of the
15 year. Thus, its calculations do not provide support for its claim of accounting
16 fraud. Similarly, Plaintiff's calculations using the bankruptcy pleadings fails to
17 take into consideration what portion of the \$170.9 million of nonperforming
18 construction loans became nonperforming in 2Q08 and in 3Q08; fails to
19 distinguish between loans to construction companies and construction loans, fails
20 to plead the maturity dates for some of the loans, and erroneously includes
21 interest, fees, and other charges in the total amount of the loans. Plaintiff's use of
22 the loan amounts gleaned from the bankruptcy proceedings is speculative.

23 In short, Plaintiff has failed to allege that the statements made by
24 Defendants were misleading. Nothing in the quarterly statements was intended to
25 give a reasonable investor an impression of a state of affairs that differed in a
26 material way from the one that actually existed. *See In re Cutera Sec. Litig.*, 610
27 F.3d at 1108. Plaintiff's speculative approach in alleging that Defendants falsely
28

1 represented that Sterling's financial reporting was accurate fails the particularity
2 requirements of the PSLRA.

3 **4. Fraud by Hindsight**

4 Case law makes clear that a plaintiff may not plead "fraud by hindsight," *i.e.*
5 a complaint may not simply contrast a defendant's past optimism with less
6 favorable actual results. *See In re Vantive Corp. Sec. Litig.*, 283 F.3d 1079, 1084-
7 85 (9th Cir. 2002) *abrogated on other grounds by South Ferry LP, No.2 v.*
8 *Killinger*, 542 F.3d 776, 784 (9th Cir. 2008) ("The purpose of this heightened
9 pleading requirement was generally to eliminate abusive securities litigation and
10 particularly to put an end to the practice of pleading "fraud by hindsight.").

11 Although Plaintiff's complaint contains additional allegations to
12 demonstrate unsafe and unsound practices and fraudulent financial reporting, such
13 as unwise lending practices, overstatement of goodwill in 2Q08 and 3Q08, false
14 and misleading statements about the reasons for the unexpected loan losses and
15 goodwill impairment, failing to maintain an adequate ALLL, and failing to obtain
16 updated appraisals or valuations, these allegations reflect an in-hindsight
17 assessment of Defendants' performance and conduct during a time of
18 unprecedented global economic collapse. These allegations do not meet the
19 pleading requirements of the PSLRA. *See Novak v. Kasaks*, 216 F.3d 300, 309
20 (2nd Cir. 2000) ("[A]llegations that defendants should have anticipated future
21 events and made certain disclosures earlier than they actually did do not suffice to
22 make out a claim of securities fraud."). Without specific allegations that
23 Defendants either knew or recklessly disregarded the falsity of its own statements
24 at the time the statements were made, the fact that the statements later turned out
25 to be false is irrelevant to a cause of action under the PSLRA.

26 It is worth noting at this point that Defendants' public statements
27 immediately before and during the Class Period were not exclusively positive or
28 optimistic. Defendants consistently recognized that the economy was in turmoil

1 and that Sterling was struggling to identify and properly value troubled assets.
2 Defendants were exercising legitimate business judgment in a transparent manner.
3 The fact that some of these decisions and judgments proved later to be wrong is
4 not actionable.

5 **5. Section 20(a) Claim**

6 Because Plaintiff has failed to adequately plead a primary violation of
7 section 10(b) of the Securities Exchange Act of 1934, Plaintiff's section 20(a)
8 claim is summarily dismissed. *See Zucco Partners, LLC*, 552 F.3d at 990.

9 **6. Leave to Amend**

10 Fed. R.Civ. P. 15 instructs the Court to freely give leave to amend
11 when justice so requires. However, "where the plaintiff has previously been
12 granted leave to amend and has subsequently failed to add the requisite
13 particularity to its claims, the district court's discretion to deny leave to
14 amend is particularly broad." *Zucco Partners, LLC*, 552 F.3d at 1007.

15 Here, Plaintiff's underlying premise in its original consolidated complaint
16 and its amended consolidated complaint is that Defendants engaged in unsafe and
17 unsound banking practices, and investors were misled when Gilkey reassured
18 them Sterling was practicing safe and sound banking practices. The Court has
19 twice found that the use of the term "safe and sound" by Gilkey cannot support a
20 securities fraud claim. Additionally, the Court has twice found that Plaintiff's
21 allegations regarding its accounting and financial reporting may reflect poor
22 business judgment, but they do not rise to the level of securities fraud. Plaintiff has
23 essentially re-plead the same legal theories with some additional facts that do not
24 change the outcome of the case. Consequently, the Court finds that granting
25 Plaintiff's leave to amend would be futile and would result in undue prejudice to
26 Defendants as this litigation has been pending for over five years.

27 Plaintiff's request for leave to amend is denied.

28 ///

Accordingly, **IT IS HEREBY ORDERED:**

1. Defendants' Request for Judicial Notice and Notice of Incorporation, ECF No. 119, is **GRANTED**, in part, and **DENIED**, in part.

2. Defendants' Supplemental Request for Judicial Notice and Notice of Incorporation by Reference, ECF No. 126, is **GRANTED**, in part, and **DENIED**, in part.

3. Defendants' Motion to Dismiss Consolidated Amended Complaint for Violation of the Federal Securities Laws, ECF No. 113, is **GRANTED**.

4. The above-captioned case is **dismissed**, with prejudice.

IT IS SO ORDERED. The District Court Executive is hereby directed to file this Order, provide copies to counsel, and close the file.

DATED this 17th day of September, 2014.



Stanley A. Bastian

Stanley A. Bastian
United States District Judge